Sanlam Lifestage Feedback Report
Quarter 3 2016

Sanlam

Employee Benefits

Insurance | Financial Planning | Retirement | Investments | Wealth

Contents

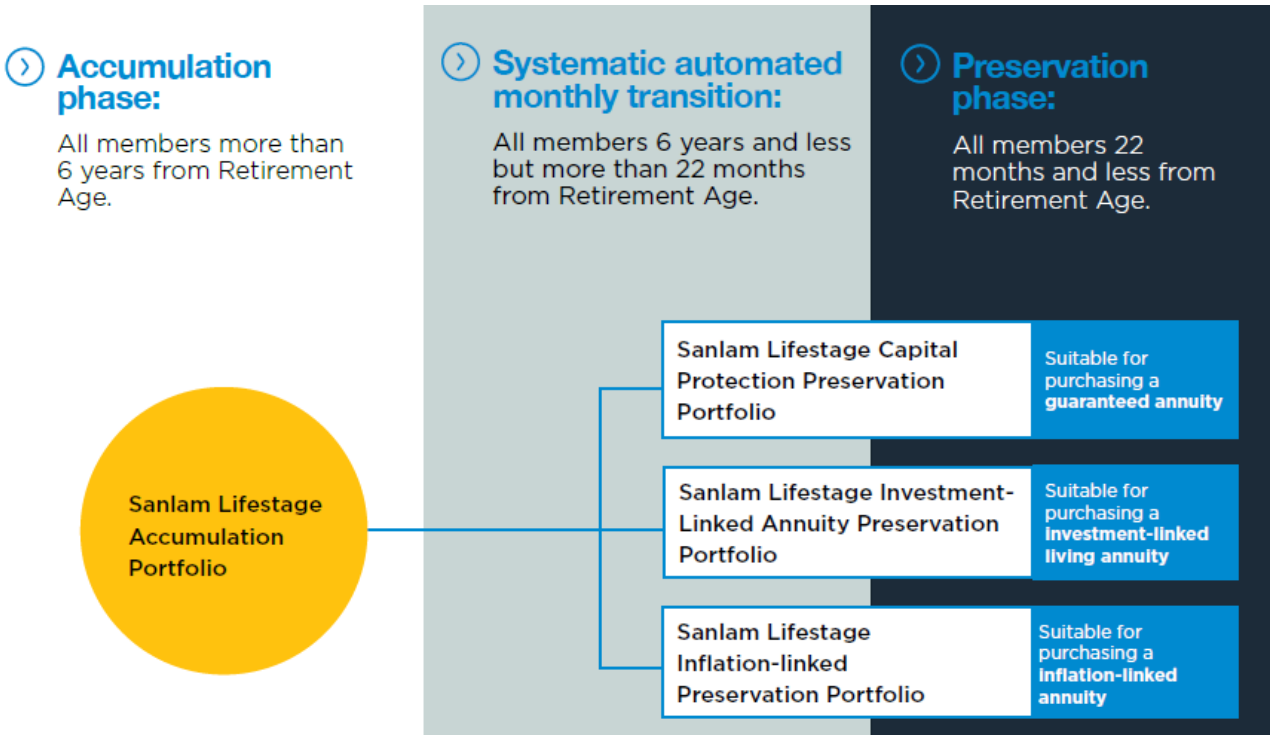
How does Sanlam Lifestage work?

Sanlam Lifestage aims to meet a member's retirement savings requirement in a single seamless investment solution, designed to adapt to the member's time remaining to retirement and income needs after retirement.

In terms of the lifestage approach, a member's savings are initially invested in a portfolio that places emphasis on long-term capital growth with some tolerance for short-term market volatility. As retirement approaches, a member's savings are automatically switched to a preservation portfolio. A preservation portfolio protects a member against the specific risks inherent in the purchase of the particular annuity the member is targeting to obtain an income in retirement.

As members may employ a range of different income strategies at retirement, 3 Sanlam Lifestage Preservation Portfolios are available, each designed to align capital to an income strategy for an almost seamless transition into retirement.

Transition from the accumulation phase to the preservation phase takes place by means of 50 monthly switches, starting 6 years prior to retirement, to reduce market timing risk. The transitioning switches that shift exposure from the Sanlam Lifestage Accumulation Portfolio to the Sanlam Lifestage preservation portfolios are calculated and implemented monthly based on members' actual ages. Members may plan to retire earlier than the normal retirement age determined by their employer, if this is allowed by their retirement fund. In such cases, planned retirement dates instead of normal retirement ages can be used to determine the timing of the transitioning process. This is done at no additional cost to the member.



The Capital Protection Preservation Portfolio is appropriate for a member wishing to purchase a guaranteed annuity at retirement, or who is uncertain on which annuitisation strategy they wish to employ at retirement. The Inflation-linked Preservation Portfolio is appropriate for a member wanting to purchase an inflation-linked annuity at retirement, and the ILLA Preservation Portfolio for a member who plans to manage their income in retirement through an Investment-linked Living Annuity (ILLA).

Investment Portfolios offered in Sanlam Lifestage

Accumulation Portfolio

The Sanlam Lifestage Accumulation Portfolio aims to provide market-related capital growth to members who are more than six years from retirement and who need to grow their retirement savings.

The portfolio is a multi-managed portfolio which allocates its assets across equity, bond, property and cash sub-portfolios. In the case of each domestic sub-portfolio a core-satellite investment strategy is employed. The core is a low-cost index-tracking strategy, around which the satellite managers aim for active returns through the out-performance of their respective benchmarks.

The portfolio has an aggressive risk profile.

Preservation Portfolios

Capital Protection Preservation Portfolio

The Sanlam Lifestage Capital Protection Preservation Portfolio invests in the Sanlam Stable Bonus Portfolio. The portfolio aims to protect the invested capital. The Stable Bonus Portfolio provides investors with exposure to the financial markets, while protecting them against adverse market movements.

This is achieved by smoothing the returns over time and offering capital protection on the net contributions invested together with the vested bonuses in case of resignation, retirement, death, retrenchment or disability. A bonus is declared monthly in advance, which consists of a vesting and non-vesting component. Bonuses cannot be negative.

The portfolio has a conservative risk profile.

Inflation-linked Preservation Portfolio

The Sanlam Lifestage Inflation-linked Preservation Portfolio aims to provide members nearing retirement with the ability to buy a post-retirement income that will grow in line with inflation after retirement. As such, the investment portfolio may fluctuate when interest rates rise or fall, as it aims to match the movement in purchasing prices of inflation-linked annuities rather than protect or maximise growth of capital in the short term.

The Sanlam Lifestage Inflation-linked Preservation Portfolio invests in a long-duration bond portfolio, the Sanlam Employee Benefit Inflation Annuity Tracker portfolio, where the benchmark for this portfolio is the SALI Real. The SALI Real has been developed by Sanlam to track the cost of purchasing an inflation-linked annuity.

The portfolio has a conservative risk profile.

Living Annuity (ILLA) Preservation Portfolio

The Sanlam Lifestage Living Annuity Preservation Portfolio aims to provide moderate market growth. This portfolio is suitable for members who want to invest in an investment-linked living annuity at retirement. The Sanlam Lifestage Living Annuity Preservation Portfolio allocates its assets across equity, bond, property and cash sub-portfolios.

In the case of each domestic sub-portfolio a core-satellite investment strategy is employed. The core-satellite is a low-cost index-tracking strategy, around which the satellite managers aim for active returns through the outperformance of their respective benchmarks.

This portfolio has a moderate risk profile.

Product Commentary – Quarter ending September 2016

Global monetary policy continued to be a major theme guiding investor sentiment on global markets during the third quarter. Post Brexit the Bank of England cut rates slightly trying to ease short-term market panic, while the Bank of Japan continued to try and battle a low growth and deflationary environment by introducing some additional stimulus. In the United States the US Federal Reserve (FED) continued to debate the timing of the next interest rate increase. However the FED left rates unchanged during the quarter with the market pricing the likelihood of a rate hike in December at just over 50 percent.

Global equity markets performed particularly well during the quarter as investors had expectations of further global monetary stimulus post Brexit, with the MSCI World gaining 4.4% (USD). The low interest rates and low growth in developed markets has resulted in investors looking toward emerging markets for both capital growth and yield with the MSCI Emerging Market gaining 8.3% (USD). Global bonds were only up 0.5% (USD), while emerging market bonds were up 3.1% (USD).

Locally, markets experienced quite a bit of volatility. There was a high degree of political risk that occurred during the quarter with rising tensions being reported between President Jacob Zuma and Finance Minister Pravin Gordhan. This created short-term volatility for the Rand. However, improved commodity prices, the search for yield and the continued delay by the FED in deciding to increase interest rates strengthened the Rand against the dollar during the quarter as it gained 7.7%. The All Share Index was slightly up returning 0.5% (ZAR). The strengthening Rand was a major detractor with dual listed companies and those that earn a large proportion of the income abroad negatively affected. Financials and industrials were down -1.7% and -3.0% respectively (both ZAR). The Rand and the improving inflation outlook provided the South African Reserve Bank with some breathing room during the September meeting with the bank keeping rates unchanged. As a result South African bonds were the top performer locally gaining 3.4% (ZAR) while South Listed Property was slightly down, losing -0.7% (ZAR). Cash was up 1.9% (ZAR).

There continues to be concern about the resilience of the South African economy, with consumers coming under increased pressure. Mr Price (MRP) reported poorer than expected results and noted the warmer winter and poor consumer spending as contributing factors. Woolworth (WHL) also noted weak sales growth in the clothing component of their business, while food sales growth remained strong. Longer sales periods were prevalent in many malls. Weak economic growth, albeit an improvement in the second quarter in comparison to the first quarter, continued to be a major concern particularly with the threat of a ratings downgrade hanging over South Africa in December.

However lack of growth is not just a South African problem as Central Banks continue to struggle to get market growth moving forward despite the biggest monetary stimulus exercise in history. In addition, political tensions as well as socio-economic issues continue to make headlines worldwide, especially with the gap between richer and poorer getting bigger globally over the last decade, with many economists suggesting the the monetary stimulus programmes have mostly benefitted the wealthy at the expense of the poor which is partly why economic growth remains stubbornly low.

The important take-away is that the low growth environment is likely to remain in place for a while and hence why the search for yield continues. Thus from a South African and global investor perspective, South African Bonds continue to look attractive despite the risks given yields above 9% on the All Bond Index. When almost 50% of the global bond market is on negative yields one can understand why such a yield looks attractive, which is why South Africa has experienced net foreign inflows into the Bond market.

Equity markets, more so locally than globally, look expensive and cash is looking increasingly attractive in the short term given the downside risk inherent in some of these equity and bond markets globally. Expectations become important in environments such as this and one feels that it becomes more important to protect capital in environments such as this than it is to have high levels of risk in the portfolio as returns from asset classes become more muted as global economic growth and inflation remain low.

Portfolio Commentary – Quarter ending September 2016

Sanlam Lifestage Accumulation Portfolio

The portfolio outperformed its benchmark over the quarter.

Asset allocation was neutral over the quarter. The overweight to foreign assets detracted value, particularly with the Rand strengthening towards the end of the quarter. Whilst the overweight to hedge funds and overweight to domestic bonds added value during the quarter.

Manager selection added value, driven by the good performance of the domestic equity managers. Coronation in particular had a great quarter, whilst Denker also outperformed the benchmark strongly. First Avenue underperformed the benchmark.

Sanlam Lifestage Capital Protection Preservation Portfolio

The Sanlam Capital Protection Preservation Portfolio continues to be a safe haven for our members during these volatile markets. The smoothing and guarantees offered by this portfolio means that there is no need for Lifestage members to panic. The stable and predictable monthly bonuses reduces the temptation to make emotional decisions during uncertain times, such as switching to more conservative investment options and thereby locking in losses when markets are down.

Sanlam Lifestage Inflation Linked Preservation Portfolio

The portfolio aims to closely match movements in its benchmark index, the SALI Real by investing in inflation-linked bonds. This index tracks the changes in the cost of an inflation linked annuity caused by changes in real interest rates. The portfolio therefore aims to preserve a member's ability to purchase an inflation linked annuity.

Sanlam Lifestage ILLA Preservation Portfolio

The portfolio outperformed its benchmark over the quarter.

Asset allocation was a positive contributor over the quarter. The underweight to foreign bonds added value. Whilst the overweight to hedge funds and overweight to domestic bonds in particular added value during the quarter.

Manager selection also added value, driven by the good performance of the domestic equity managers. Coronation in particular had a great quarter, whilst Denker also outperformed the benchmark strongly. First Avenue underperformed the benchmark.

Fund Fact Sheets

Sanlam Lifestage

Mandate description

Sanlam Lifestage is the Fund's trustee approved default investment strategy and aims to meet each member's savings requirement by working towards a target date, which would be the Normal Retirement Age or the Planned Retirement Age (if different).

How Sanlam Lifestage works

The investment strategy consists of two phases and members are automatically switched from one phase to another as they near retirement. The two phases are:

- Accumulation phase
- Preservation phase

As retirement approaches, this target date strategy invests in an investment portfolio matching the member's postretirement needs or plans, but in the years prior to this greater emphasis is placed on achieving capital growth. Members with more than 6 years before reaching their Normal Retirement Age or Planned Retirement Age (if different) are fully invested in the Sanlam Lifestage Accumulation Portfolio which aims to achieve capital growth. Six years (72 months) before a member reaches his/her Normal Retirement Age or Planned Retirement Age (if different), the member is gradually switched from the Sanlam Lifestage Accumulation Portfolio to his/her selected Sanlam Lifestage preservation portfolio by means of 50 monthly switches.

Members with more than 6 years before reaching their Planned Retirement Age are fully invested in Sanlam Lifestage Accumulation Portfolio which aims to achieve capital growth.

Six years (72 months) before a member reaches his/her Planned Retirement Age, the member is gradually switched from the Sanlam Lifestage Accumulation Portfolio to his/her selected Sanlam Lifestage preservation portfolio by means of 50 monthly switches.

Fund performance

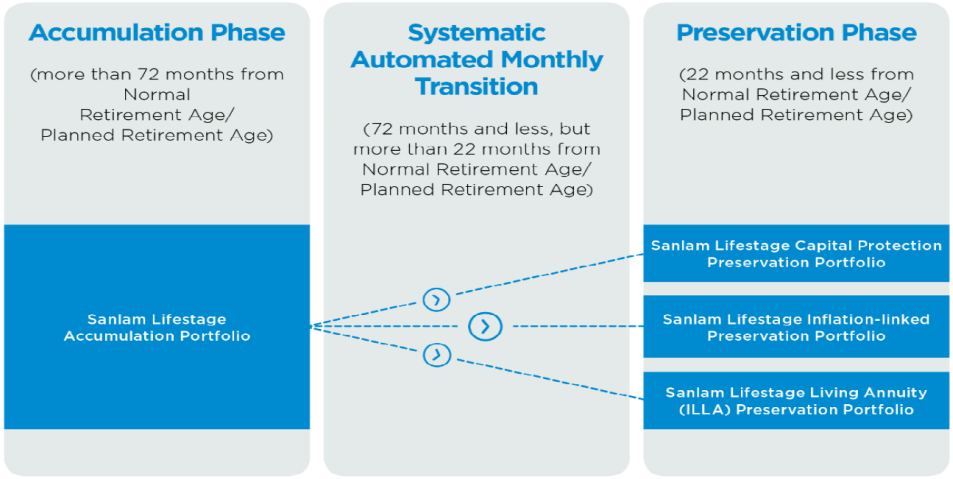
Phase	1 month	3 months	1 year	3 years
Accumulation Portfolio	-1.5%	0.2%	8.2%	10.1%
Preservation Portfolios:				
Capital Protection	0.7%	2.2%	9.2%	13.9%
Inflation-Linked	0.5%	0.3%	8.5%	8.8%
Living annuity (ILLA)	-0.9%	0.8%	9.7%	9.8%

Please note:

Sanlam Lifestage investment reporting only commences from 1 August 2013, but the following longer term performance was achieved applicable to members previously invested in the Accumulation Phase of the Sanlam Umbrella Fund's discontinued Lifestage Programme, and whose investments were transitioned to Sanlam Lifestage during the month of July 2013.

Note because the change in lifestage models involved a fundamental change in the investment mandates, this past performance should not be regarded as the back-tested track record of Sanlam Lifestage.

Phase	1 month	3 months	1 year	3 years
Sanlam Umbrella Fund Accumulation	-1.5%	0.2%	8.2%	10.1%



Sanlam Lifestage Accumulation Portfolio

Period Ending	30-Sep-16
Fund Size	R 7,156 million
Inception Date	Jul-13

Fund objective

The fund is an aggressive portfolio displaying high levels of volatility over the short term and is aiming to provide market related growth.
Scrip lending may be performed on the passive equity component.

Risk profile

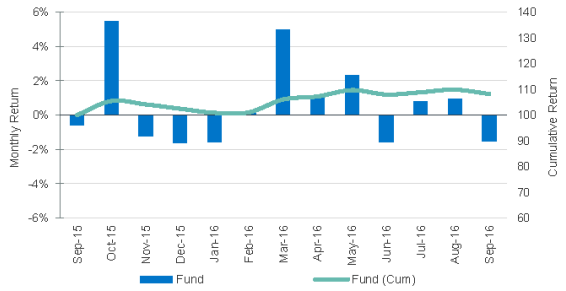
This portfolio has an moderate-aggressive risk profile

Fees

1.00% per annum for the first R50m
0.90% per annum on the portion of assets between R50m - R100m
0.775% per annum on the portion of assets between R100m – R300m
0.70% per annum on the portion of assets between R300m – R500m
0.65% per annum on the portion above R500m

All Sub-funds invested in Sanlam Lifestage Accumulation Portfolio are charged the highest investment management fee applicable to the first tranche of assets, and Sub-funds with greater than R50 million assets are separately rebated any savings due to the sliding investment management fee scale on a monthly basis.The underlying investment managers may be incentivised on a performance fee basis.

Monthly and cumulative returns



Fund performance (%)

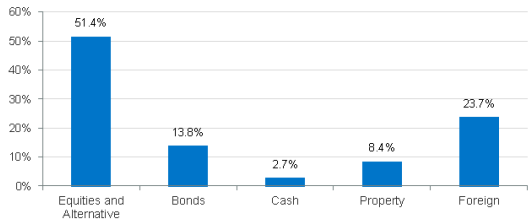
	Fund	Benchmark
1 Month	-1.5%	-1.3%
3 Months	0.2%	-0.1%
6 Months	2.0%	1.8%
1 Year	8.2%	9.2%
3 Years	10.1%	12.0%
5 Years	n/a	n/a

Top 10 holdings (% of Equities)

Share Name	% of Equities
Naspers	16.9%
British American Tobacco Plc	5.5%
Steinhoff Int Hldgs N.v	4.1%
Sasol Limited	3.2%
Firstrand Limited	3.1%
Standard Bank Group Limited	3.0%
MTN Group	2.8%
Old Mutual	2.7%
Anglo American	2.0%
Remgro Limited	1.9%

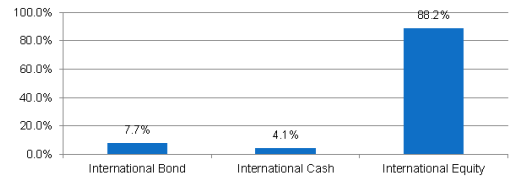
Benchmark
55% FTSE / JSE Shareholder Weighted Index
4% BEASSA Total Return Index
10% FTSE/JSE SAPY Index
11% Short Term Fixed Interest Index (STeFI)
20% MSCI World (Developed Markets) Equity Index

Asset class breakdown



The benchmark reflects the fund's long-term strategic asset allocations. Fund asset allocations may be allowed to vary from the benchmark, depending on market conditions.

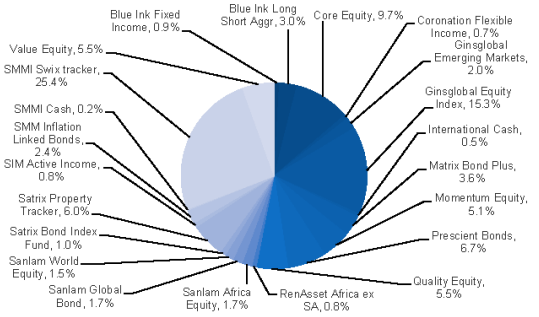
Foreign split



Equity sectoral exposure (%)

	Fund	Benchmark
Financials	21.7%	18.8%
Resources	14.2%	19.8%
Industrials	64.1%	61.4%

Fund manager breakdown



Please refer to the "Local equity manager breakdown for SMMI portfolios" page for a detailed outline of the underlying equity managers within this portfolio.

Risk analysis
(based on the last 3 years' monthly returns)

% of negative months over the last 3 years	30.6%
Average capital loss in one month	-1.3%
Downside risk *	0.9%

* Downside risk is measured as the standard deviation of the underperformance of the portfolio relative to CPI

Sanlam Lifestage Capital Protection Preservation Portfolio

Period Ending	30-Sep-16
Fund Size (Book Value)	R 1 248 million
Inception Date	Aug-13

Fund objective

The Portfolio offers investors stable, smoothed returns with a partial guarantee on benefit payments. A bonus, which consists of a vesting and non-vesting component is declared monthly in advance. Bonuses cannot be negative. The portfolio offers 100% capital guarantee and partially vesting bonuses.

Risk profile

The portfolio has a conservative risk profile

Fees

Sanlam's cost in relation to the investment plan is recouped by recovering the following fees:

Investment Management Fees:

0.425% per annum

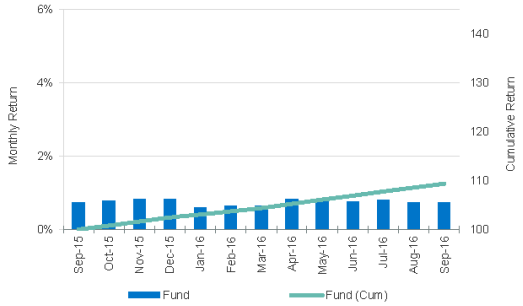
Guarantee Premium:

A guarantee premium of 0.90% per annum

Annual Performance Linked Fee:

The investment manager may be incentivised with performance fees (capped at 0.30% p.a.)

Monthly and cumulative bonuses



Fund bonuses (%)

	Fund (gross of fees)
1 Month	0.7%
3 Months	2.2%
6 Months	4.7%
1 Year	9.2%
3 Years	13.9%
5 Years	n/a

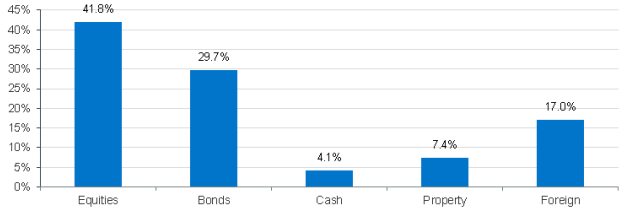
Top 10 equity holdings (% of Equities)

Share Name	% of Equities
Naspers N	16.9%
BTI Group	5.4%
ATTACQ Limited	4.3%
Sasol	4.1%
MTN Group	3.8%
Steinhoff (SNH)	3.6%
Stanbank	3.6%
FirstRand / RMBH	3.5%
Old Mutual	3.4%
Sanlam	2.0%

Benchmark

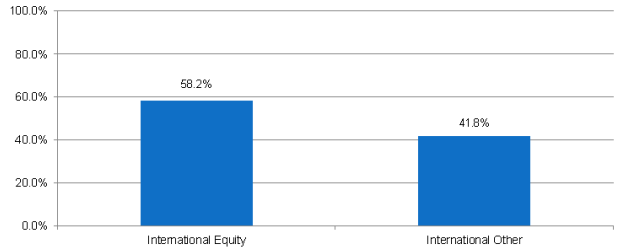
42.0%	SWIX (Shareholder Weighted Index)
25.5%	BEASSA Total Return All Bond Index
1.0%	STeFI + 2%
2.0%	Barclays BESA Gov. Inflation-linked Index
7.5%	MSCI World Index (Dev. Markets)
5.0%	Barclays Global Aggregate Index
2.5%	HFRI Fund of Funds Composite Index
8.0%	STeFI Index
6.5%	BEASSA 7-12 years TRI plus 1.0% p.a.

Asset class breakdown



The benchmark reflects the fund's long-term strategic asset allocations. Fund asset allocations may be allowed to vary from the benchmark, depending on market conditions.

Foreign split



Equity sectoral exposure (%)

	Fund
Financials	19.8%
Resources	13.1%
Industrials	67.1%

The Non - Vested bonuses as a proportion of the total Sanlam Stable Bonus Portfolio holdings:

Sanlam Umbrella Pension Fund	6.72%
Sanlam Umbrella Provident Fund	8.94%

** Only impacts Sanlam Lifestage members opting for this preservation strategy in the last 6 years before retirement.*

Sanlam Lifestage Living Annuity Preservation Portfolio

Period Ending	30-Sep-16
Fund Size	R 38 million
Inception Date	Oct-13

Benchmark	40% FTSE / JSE Shareholder Weighted Index
	20% BEASSA Total Return Index
	13% Short Term Fixed Interest Index (STeFI)
	10% FTSE/JSE SAPY Index
	17% Barclays BESA Gov. Inflation-linked Index

Fund objective

The relatively high equity allocation of the Fund should occasionally result in high volatility but also a high rate of growth compared to funds with a moderate risk profile.

Risk profile

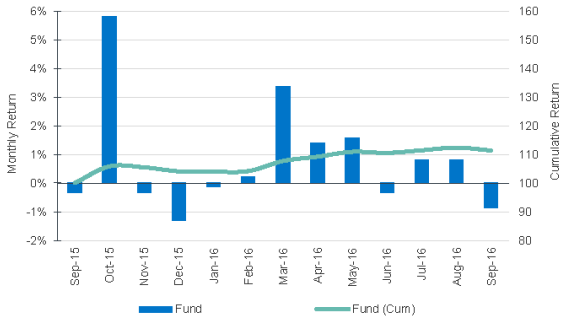
The portfolio has a moderate risk profile.

Fees

Investment Management Fees:
0.80% per annum.

The underlying investment managers may be incentivised on a performance fee basis.

Monthly and cumulative returns



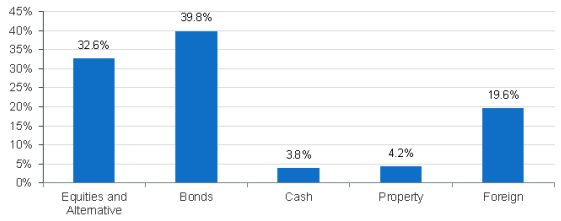
Fund performance (%)

	Fund	Benchmark
1 Month	-0.9%	-0.4%
3 Months	0.8%	0.5%
6 Months	3.4%	3.2%
1 Year	9.7%	8.9%
3 Years	9.8%	10.1%
5 Years	n/a	n/a

Top 10 equity holdings (% of Equities)

Share Name	% of Equities
Naspers	17.0%
British American Tobacco Plc	5.5%
Steinhoff Int Hldgs N.v	4.1%
Sasol Limited	3.2%
Firstrand Limited	3.1%
Standard Bank Group Limited	3.0%
MTN Group	2.8%
Old Mutual	2.7%
Anglo American	2.0%
Remgro Limited	1.9%

Asset class breakdown



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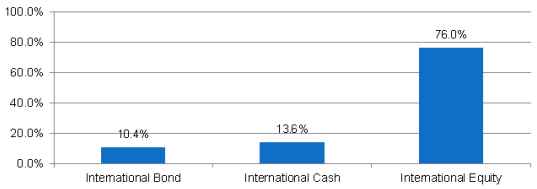
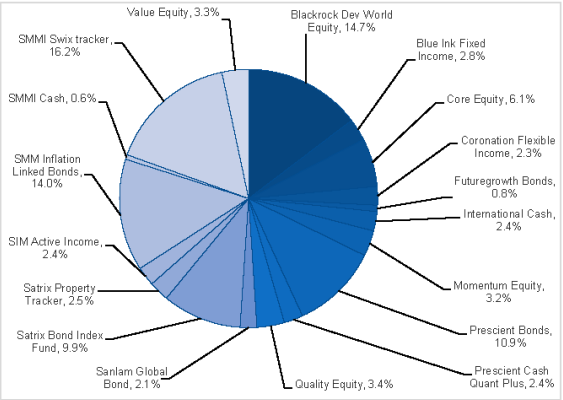
Foreign split



Equity sectoral exposure (%)

	Fund	Benchmark
Financials	21.9%	18.8%
Resources	14.1%	19.8%
Industrials	64.0%	61.4%

Fund manager breakdown



Please refer to the "Local equity manager breakdown for SMMI portfolios" page for a detailed outline of the underlying equity managers within this portfolio.

Sanlam Lifestage Inflation-linked Preservation Portfolio

Period Ending	30-Sep-16
Fund Size (Book Value)	R2 million
Inception Date	Aug-13

Benchmark Sanlam Asset Liabilty Index Real (inflation linked)

Fund objective

The portfolio aims to closely match movements in its benchmark index, the SALI Real. This index tracks the changes in the cost of an inflation linked annuity caused by changes in real interest rates. The portfolio therefore aims to preserve a member's ability to purchase an inflation linked annuity.

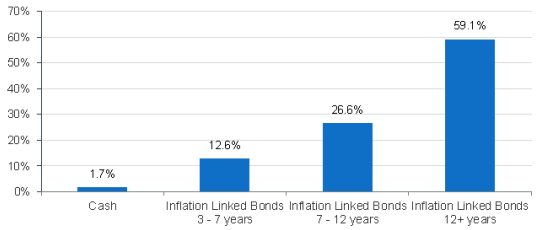
Risk profile

This fund has a conservative risk profile

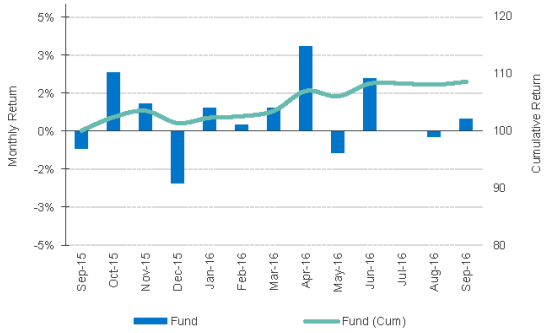
Fees

Investment Management Fees:
0.70% per annum.

Asset class breakdown



Monthly and cumulative bonuses



Fund bonuses (%)

	Fund (gross of fees)	Benchmark
1 Month	0.5%	0.6%
3 Months	0.3%	0.3%
6 Months	4.9%	5.1%
1 Year	8.5%	8.6%
3 Years	8.8%	9.1%
5 Years	n/a	n/a

Local equity manager breakdown for SMMI portfolios

Underlying Manager Breakdown

	Lifestage Accumulation	SMM 70 Portfolio	SMM 50 Portoflio	SMM 30 Portfolio	ILLA Preservation
Domestic Equity					
Core Equity					
Fairtree Equity	2.0%	4.1%	2.9%	1.4%	1.2%
Truffe Equity	1.9%	4.0%	2.9%	1.4%	1.2%
ABAX Eqity	1.9%	4.0%	2.9%	1.4%	1.2%
Coronation Equity	2.6%	5.4%	3.9%	1.9%	1.6%
Sentio Equity	1.3%	2.7%	1.9%	1.0%	0.8%
Quality Equity					
First Avenue	2.0%	4.2%	3.0%	1.5%	1.2%
Steyn Equity	1.6%	3.4%	2.5%	1.2%	1.0%
Bataleur Equity	1.9%	4.0%	2.8%	1.4%	1.2%
Momentum Equity					
Kaizen Thematic Equity	1.9%	4.0%	2.9%	1.4%	1.2%
Satrix Momentum	1.9%	4.0%	2.9%	1.4%	1.2%
Capricorn Equity	1.3%	2.7%	1.9%	1.0%	0.8%
Value Equity					
ABSA Select Equity	1.6%	3.3%	2.3%	1.1%	1.0%
Investec Value	2.0%	4.1%	2.9%	1.4%	1.2%
SIM General Equity	2.0%	4.1%	2.9%	1.4%	1.2%
Passive Equity					
SMMI Swix tracker	25.4%	0.0%	0.0%	0.0%	16.2%

Performance vs Benchmark

Performance to end September 2016

Sanlam Lifestage	1 Month	3 Months	6 Months	1 Year	3 Year
Accumulation Portfolio	-1.52%	0.19%	2.01%	8.21%	10.08%
Benchmark	-1.27%	-0.09%	1.84%	9.19%	11.96%
Capital Protection Preservation*	0.73%	2.23%	4.70%	9.21%	13.88%
Inflation-Linked Preservation Portfolio	0.48%	0.29%	4.91%	8.53%	8.80%
Benchmark	0.57%	0.25%	5.08%	8.62%	8.97%
ILLA Preservation Portfolio	-0.87%	0.76%	3.43%	9.73%	n/a
Benchmark	-0.37%	0.46%	3.18%	8.90%	n/a

** The Capital Protection Preservation Portfolio does not have an explicit benchmark.*

Performance Attribution

Multi-Managed Portfolios:

3 months ending September 2016	Active Return	Tactical Asset Allocation	Manager Selection
Sanlam Lifestage Accumulation	0.29%	0.05%	0.24%
Sanlam Lifestage ILLA Preservation	0.31%	0.21%	0.10%

The Sanlam Lifestage Accumulation Phase fund outperformed its benchmark over the quarter ending 30 September 2016.

Manager selection was the largest contributor to performance whilst allocation detracted from performance. An underweight allocation to Domestic equity, domestic cash which had positive return as well as over allocation to international equities and international cash which detracted performance on the back of the rand appreciating detracted from performance. An overweight allocation to domestic bonds, more especially to the long duration bonds as well as an underweight allocation to international bonds contributed to performance.

Local Equity managers were the largest contributors to performance with manager selection of Coronation, Allan Gray and SMMI tracker contributing the most to performance.

The Sanlam Lifestage Living Annuity outperformed its composite benchmark over the quarter ending 30 September 2016.

Equity allocation to industrials, financials, an increased exposure to resources as well as higher exposure to medium to long duration contributed to performance while exposure to international assets detracted performance as the rand appreciated over the quarter.

Stock selection contributed to performance through overweight positions in Naspers, FirstRand, Standard Bank and an underweight positions in MTN while overweight positions in BAT, Steinhoff, Old Mutual and Remgro as well as an underweight position in Anglo American detracted performance.

Please refer to the portfolio commentary for insight into performance of the Sanlam Capital Protection and Inflation-Linked Preservation Portfolios. These portfolios do not provide comparable information to the above due to the unique nature of their structure and mandate.

Economics

October 2016

Executive summary

Asset class diversification was the central theme in global capital markets in Q3 with risky assets outperforming their defensive counterparts. At the global level, emerging market equities and high yield credit came out tops whereas developed markets bonds and global listed property brought up the year. On the domestic front, a sharp appreciation in the rand underpinned domestic asset class returns, with SA bonds outperforming both equities and listed property. Due to rand appreciation, domestic asset classes outperformed their global peers. Ongoing political uncertainty amid allegations of "State Capture" and the lack of reform at SOE's remains the single biggest headwind facing the economy in the final quarter of the year. Despite the risk of a ratings downgrade, domestic bonds have been upweighted to overweight from neutral, while listed property has been upweighted to neutral from underweight. An averaging-in strategy is proposed given our base case view that two of the three ratings agencies are unlikely to downgrade SA to "junk".

Over the longer term, the risk of higher global bond yields has increased on the back of rising inflation expectations and an expected tapering off of QE given the diminishing economic benefits of these programmes. In addition, the political shift globally to more populism is also likely to serve as a catalyst for higher bond yields as fiscal spending rises. With the discount rate increasing, equity market valuations may need to adjust with obvious implications for prices. Since populism will lead to increased protectionism and a resultant slowdown in global trade and global growth, the magnitude of the rise in bond yields may yet be tempered, softening the repricing across asset classes. The implication is that investors need to balance their risk asset exposure with an absolute return mindset in order to provide the necessary downside protection and diversification benefits needed in the current uncertain environment.

Highlights

- US Fed signals December rate hike
- US election uncertainty weighs of risk trade
- IMF warns of protectionism on trade and growth
- Global debt unlikely to derail growth
- Oil prices rebound on OPEC production cuts
- BoJ shifts policy to managing yield curve
- Banks rally on BoJ
- SA MPC signals rates may have peaked
- SA "State capture" adds to ratings downgrade risk

Global Equities

Global equities gained a healthy 4.4% in USDs but -3.0% in rands as a delay to a Fed funds rate hike and a rebound in European, US and Japanese financials underpinned equities. UK stocks recovered strongly from their Brexit-induced weakness following the shock referendum result. The FTSE in GBP's delivered 7.8% over the quarter due to the sharp depreciation in the pound, while rallies in emerging and commodity markets underpinned global $-returns. US stocks yielded positive returns with the S&P500 returning some 3.9% in USDs. Speculation that interest rates would be increased in September caused some uncertainty in markets but these subsided after the FOMC meeting. The actions of central bankers to keep a lid on interest rates, along with a rebound in the oil price also fuelled positive investor sentiment. European equities benefitted from the expansion of QE by the ECB, while Japanese shares rallied early in the quarter to overcome a late sell-off. Expectations of further economic stimulus grew after the ruling party won an outright majority in the July elections. Currency movements also had a significant effect on Japanese shares, given the high concentration of exporters in the mix. With respect to emerging markets, they outperformed their developed market counterparts, supported by higher prices for oil, metals and other commodities, as well as a weaker USD. Markets like

Russia, Brazil and China were the main beneficiaries, helping to underpin the MSCI Emerging Markets index which returned some 8.3% in USDs over the quarter.

At the beginning of the year, the Fed was expected to raise the policy rate four times in 2016. This did not materialise due to the slower than expected economic recovery, especially in H1. However, following the September FOMC meeting, the Fed indicated that the case for a rate hike had strengthened with three members dissenting from the decision to hold off on raising rates. The September FOMC meeting confirmed that Fed officials would continue nudging monetary policy towards a normalised stance. Based on the market reaction, policy makers successfully executed a hawkish hold, deferring rate action while reinforcing expectations for a move before year-end. By then, the market will also know the outcome of the US elections.

Opinion polls suggest a Trump victory is unlikely, but if the Brexit vote has taught investors anything, it is that political sentiment in financial capitals is not always a reflection of the views of the nation as a whole. Global equity markets have recovered from their initial post-Brexit losses, while the significant depreciation in the GBP has supported UK equities. In Europe, the focus over the quarter was centred on the banking sector as banking shares fell sharply in the wake of the Brexit vote. Although it is unlikely that there will be a systemic failure of banks in Europe, in the last week of September Deutsche Bank came under immense selling pressure. With Deutsche Bank having received funding from Qatar's Royal Family for a 20% stake, systemic risk in the global banking system has abated for now. The biggest risk facing the Eurozone over the coming quarter is the outcome of the Italian constitutional referendum which could result in the ousting of the Matteo Renzi.

Against the backdrop of committed timelines for ongoing monetary stimulus in the UK, Japan and the Eurozone over the medium term, the added liquidity coupled with still low interest rates should be supportive of risky assets. Post the 2008 recession, risk assets were buoyed by QE stimulus rather than inflation expectations, although more recently the boost from QE has shown diminishing benefits. Due to more stringent capital adequacy requirements for banks, the unintended consequence of QE has been pedestrian credit demand, weak aggregate demand and benign capital expenditure. The case for increased fiscal stimulus is growing ever louder given the leeway some countries now have in raising their fiscal deficits following years of fiscal austerity. The aggregate of total worldwide debt at governments, households and non-financial corporations has risen at an annual growth rate of 4.2% since 2008, which is only slightly in excess of the nominal growth rate of the world economy. Measured as a percentage of GDP, total debt held by this group has increased from around 220% in 2008 to 230% in 2015. It is an increase, but the 10%-point rise is not exactly shocking. What's more, almost all of it is attributable to the increase in government debt. On aggregate, household and corporate debt as a percentage of GDP has been more or less stable around a level of 150% of GDP since 2003. These debt levels may appear to be too high, but the idea of an impending debt explosion across the board does appear to be misleading. Increased fiscal spend does however pose a risk of higher bond yields that would spill over into equity market valuations as the discount rate increases.

Evidence of a turning point in the global earnings cycle is expected to underpin investor sentiment over the coming quarters. The turning point in the earnings cycle became evident at the end of June following a 16% year/year contraction in trailing earnings. Although developed market equity valuations appear somewhat stretched relative to their 10-year averages, relative to their longer-term mean, the equity market is still fairly valued. In contrast, the price-to-normalised earnings multiple suggests that valuations are still attractive, reinforcing the equities argument. Similarly, emerging market equity valuations have also become stretched on conventional metrics, but on a normalised basis, emerging markets appear cheap. Given expectations of still low interest rates, even after a Fed rate hike, equity markets are able to sustain relatively higher earnings multiples. Further support for emerging markets is seen in the turnaround in their earnings cycle which is currently more advanced than in developed markets, suggesting demand will persist notwithstanding the macro-economic risks. Since emerging market currencies are also trading at a discount to their purchasing power parity values and the carry trade still favours the search for yield, emerging markets are somewhat insulated against macro-economic risks. Expectations of a marginally stronger rand in the year ahead supports a moderation to our offshore view as does an expected backup in global bond yields given the reduced appetite for central banks to expand QE beyond their committed timelines. As a consequence, a small overweight position is retained in both developed and emerging market equities.

Global Bonds

Global bond yields increased slightly over the quarter as inflation expectations increased and expectations of a fed funds rate hike was pushed out until December. In contrast, corporate bonds outperformed their sovereign counterparts as spreads narrowed over the quarter. While generally positive US non-farm payroll data contributed to a rise in US treasuries, Eurozone and Japanese QE kept a lid on German and Japanese bonds with the 10-year yields holding below zero percent. As a result of the low and negative bond yield environment, investors have broadened their search for yield. This search for yield has underpinned demand for emerging market bonds which gained 3.1% in USD's as spreads narrowed to 345 basis points from 376 the quarter before. Global bonds delivered a muted 0.70% in USDs and -6.5% in rands, while global corporate bonds outperformed their sovereign counterparts as spreads narrowed, returning 1.9% in USD's and -5.4% in rands. Developed and emerging market high yield bonds outperformed their sovereign counterparts, yielding 5.3% and 4.5% in USD's respectively. Gains in the USD oil price contributed to the relatively good returns. Global inflation-linkers, in turn, yielded 3.2% in USD's as real yields declined from -0.67% to -0.95% over the quarter. Demand for inflation-linkers was, in all likehood, driven by asset and liability matching stratgies of institutional investors.

Central bank intervention in the Japanese bond market remained a central theme over the quarter, with around one-third of all JGB's now being held by the central bank. The BoJ's decision to target the yield curve instead of monetary stimulus, and to anchor the 10-year bond yield at 0%, is intended to ensure a sufficient term premium in the bond market that will be supportive of banking margins. The BoJ also did not move away from its intention to overshoot its 2% inflation target, despite the fact that it has been struggling to reinflate the economy and deliver on its target. It remains questionable whether the BoJ's tweak to its QQE programme will raise inflation meaningfully and reverse the ongoing appreciation in the Yen.

With the credibility of central bank QE programmes in the balance, given the increasingly muted economic benefits from further monetary easing, the risk arises that bond markets could reprice higher, causing volatility across all other asset classes. It seems that policy makers will remain behind the curve and keep policy very accommodative. Some economists and observers believe that the Fed must begin raising interest rates sooner rather than later to ensure have enough firepower to stave off the next recession. Asset price gains have been made possible because of low interest rates driving down the cost of borrowing, encouraging speculation, and pushing investors into riskier assets. The 'keep rates at zero' arguement is based on the fact that global aggregate demand is weak and in need of a boost to reverse the trend of benign growth. SMMI is of the view that a focus on fiscal policy rather than monetary policy is needed in order to allow global growth to gain traction.

While ongoing quantitative easing in the UK, Eurozone and Japan will cap bond yields over the short to medium term, QE tapering is inevitable over the longer term which will result in a back-up in bond yields. Additional factors that could contribute to higher yields include November's U.S. Presidential election, Italy's constitutional referendum in December, Britain's start to talks on exiting the European Union in March next year and 2017 elections in both Germany and France. Since these events could bring about a more populist shift in these countries, bonds are likely to be the losers.

With global bonds being priced off the US treasury curve, the recent increases in US break-even inflation coupled with increases in the core PCE deflator and the 5-year forward break-even inflation rate, suggests that inflationary pressures are building, justifying a December rate hike. The erosion of producer margins experienced as a result of rising raw material input costs and intermediate input costs will also be passed on to the consumer in due course, further supporting somewhat higher inflation.

Since real bond yields are trading in negative territory, especially in Europe and Japan, pension and endownment funds are having to place increasing amounts of assets on risk in order to meet contractual obligations to fund pensions. This suggests that over the longer term, bond yields will need to rise in order to avert a potential collapse in life assurers. Since emerging markets offer more attractive absolute bond yields relative to their developed market counterparts, a neutral weighting is retained in emerging market bonds, while developed market bonds are underweighted. Even though currency risk remains a concern in the event that the US raises rates more aggressiverly than expected, our base case

view is that emerging market currencies are trading below their fair value, providing a cushion against an unexpected normalisation in US rates.

Global listed property declined some 0.9% in USDs and 7.5% in rands as the sector derated on higher bond yields and the pricing-in of a fedfunds rate hike in December. The price to book multiple declined from a recent high of 1.63X in July to 1.57X at the end of September, bringing the multiple closer to the historical average of 1.43X. Although still relatively expensive on this metric, the yield on listed property is trading at a meaningful premium to the yield on government bonds, supporting a neutral weighting in this asset class. Post the Fed funds rate hike expected in December, and given the belief that rates are likely to remain on hold through most of 2017, listed property will remain an attractive asset class for investors in search of yield.

SA Equities

SA equities tracked the $-performance of their emerging market counterparts higher in Q3 as the search for yield continued. The All Share Index eaked out a gain of 0.5% in rands but yielded a stunning 8.2% in USDs given the significant appreciation in the rand/USD exchange rate. Unlike their emerging market counterparts, however, domestic equities experienced net capital outflows totalling some R19.5bn, well in excess of the net inflows into the bond market, which totalled R3.9bn. Despite the net outflows, the rand appreciated strongly as concerns about the the fraud charges against the Minister of Finance abated and the foreign exchange proceeds from the AB-Inbev SAB Miller deal began to flow into the currency market. Despite the appreciation in the rand, resource stocks gained some 8.1% in rands, driven by a 5.9% increase in $-metals prices. Industrial counters came under pressure, declining some 3% as rand-hedge stocks retreated, while financials gained a more subdued 1.4% as banks rallied an impressive 9.9%.

While the better than expected Q2 GDP figures may have helped underpin domestic demand for SA stocks, the trend reversal (improvement) in the gross operating surplus points to a recovery in the JSE's earnings outlook. Top-down indicators of earnings growth, such as the BER-Barclays PMI, show a similar trend, suggesting that the current multiple of the market will improve from very over-bought levels as earnings recover. Bottom-up consensus earnings estimates concur, suggesting that earnings could grow around 22% off a low base in the year ahead, still short of the implied earnings priced into the market. Given the difference between expected and implied earnings, there is a risk of a market correction.

This risk is, however, mitigated by the high valuations attributed to rand-hedge stocks which have served as a hedge against domestic political risk. In contrast, SA Inc shares appear to be fairly valued, supporting active management (stock selection) rather than passive exposure to the market. Given the consensus earnings estimates, the All Share Index is trading on a rolling forward multiple of some 14.7X earnings, well ahead of the historical mean of around 12.8X earnings. If the top 5 rand-hedge counters are stripped out of the index, the forward multiple declines to some 12.8X earnings, in line with the mean. Since the risk of a ratings downgrade looms large later this year, not because of fiscal indiscipline but rather slow progress in reforming SOE's and ongoing political upheaval amid allegations of "State Capture", rand weakness is likely to persist in the near term. This should be supportive of rand-hedge stocks despite stretched valuations. Over the longer term, however, demand for SA Inc counters, coupled with a slightly stronger rand, an improving growth outlook and a declining interest rate cycle, should be supportive of multi-managed active funds. Although the return for the All Share Index is expected to be in line with that from cash, active managers are expected to deliver returns in excess of cash. As a consequence, a neutral weighting is retained in domestic equities.

SA Bonds

SA bonds rallied strongly in Q3 despite the material increase in political risk. Following the sell-off in the bond market in August after the NPA announced its decision to prosecute the Minister of Finance, bonds rallied in September to yield some 3.4% for the quarter. Most of these returns were generated in September with the yield on the All Bond Index declining from 9.4% to 9.1% over the month. SA corporate bonds lagged their sovereign counterparts, yielding some 3% as spreads widened slightly. Over the longer term, we expect spreads to come in as default risks improve on declining interest rate expectations and faster economic growth. Inflation-linked bonds lagged their nominal counterparts to return a subdued 0.4% for the quarter. Real yields increased from 1.8% at the end of June to 1.93% at the end of September as high break-even inflation rates favoured nominal over inflation-linked bonds. With real yields

on nominal bonds exceeding 3%, nominal bond investors were compensated for the inflation risk taken. Notwithstanding the volatility in the exchange rate, inflation expectations have moderated in recent months largely due to subdued oil prices (until recently) and expectations of lower food inflation in the year ahead.

The September MPC statement also highlighted the more favourable inflation outlook, although the Reserve Bank's estimates are still materially higher than our own estimates. In view of the attractive real yields expected from nominal bonds, this asset class is upweighted to overweight notwithstanding the risk of a ratings downgrade in November (Moody's) and December (S&P Global Ratings and Fitch Ratings). SMMI's base case view is that Moody's will downgrade SA to one notch above investment grade, bringing their rating in line with those of both S&P and Fitch. While there is a possibility that S&P could downgrade SA to "junk", their assessment will be driven less by fiscal concerns but more by political risks. The contrarian view, however, is that since the allegations of "State-capture" are now in the public domain, this is an indication of an emerging democracy and the normal functioning of Chapter 9 institutions. In the event that SA is downgraded by two of the three ratings agencies, it is difficult to estimate just how high bond yields will rise. Since credit default swap rates suggest a default is already partially priced into the bond market, a blow-out in yields will likely be limited. An averaging-in strategy closer to the ratings agency timelines is likely to be the best strategy from a market timing point of view.

In the near term, the release of the Medium Term Budget Policy Statement is another important milestone that is expected to pass the muster of the ratings agencies. While fiscal prudence is expected from the "mini-budget" under Pravin Gordhan, markets will closely watch developments in the contingent liabilities (guarantees to SOE's) component of the budget. Since the nuclear build programme is expected to be managed and implemented by Eskom rather than the DOE, no additional guarantees are expected for Eskom. Rather, in the event that the nuclear build programme does get the green light, the costs of the programme will be born by electricity users through higher tariffs.

A similar scenario to that in the bond market is expected to play out in the listed property sector, given the sensitivity of property to movements in government bond yields. SA listed property yielded some -0.7% in Q3 as the sector derated relative to bonds and distributions growth remained mired in negative territory. In September, however, distributions growth rebounded sharply from the depressed levels seen in the second half of 2015. Similarly, in absolute terms, dividends per share also increased meaningfully from low levels in Q4 2015 and Q1 2016, supporting a neutral weighting in this asset class. While there is a temption to overweight listed property in line with our bonds recommendation, the associated risks of doing so are deemed to be just too high.

SA Cash

SA cash yielded some 1.9% in Q3, ahead of all foreign asset class returns. The release of the MPC's statement following the September monetary policy meeting was quite dovish, with the Governor indicating that SA may be close to the end of the tightening cycle. The statement did not, however, commit a timeline to a cut in rates but cautioned that the overall inflation trajectory remained at the upper end of the inflation target range. With economic growth also still weak due to negative growth in private sector fixed investment and with consumption expenditure also constrained by the unfavourable employment outlook, the absence of significant positive wealth effects, and the slow pace of growth in real disposable incomes, the risks to the inflation forecast appeared to be more or less balanced at this stage. The MPC did, however, revise higher its GDP growth estimates to 0.4% this year and to 1.2% for 2017. These expectations are much in line with SMMI's 0.3% and 1.1% respectively.

Despite the favourable comments from the Reserve Bank, the money market continues to price in two further increases of some 25 basis points each between now and Q1 2017. The difference between the market's view and that of the MPC may be due to the market's anticipation of a sovereign ratings downgrade to "junk". It is worth noting, however, that the money market's expectations have moderated by a further 25 basis points over the past month. While our base case view is that interest rates have peaked, given our more favourable inflation outlook, a ratings downgrade will likely see rates increase a further 25 basis points from our base case view. Our base case scenario makes provision for a gradual normalisation in real interest rates to some 1.5% over the coming year.

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